Strange Days Indeed
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Investors may be flocking to the beach this time of year, but—in an unusual confluence of events—they're also being driven toward US stocks and Treasuries at the same time.

Stocks were indeed volatile last week, but the release of positive macroeconomic data trumped ongoing geopolitical concerns and stocks posted gains. At the same time, prices on 10-year Treasuries were bid up by investors, which resulted in falling yields. This is the continuation of a trend we've seen for several months now.

It reminds me of the chorus of a John Lennon song: “Nobody told me there’d be days like these … strange days indeed.” I can’t help but imagine that’s what many investors are thinking this summer, with the S&P 500 above 1,950 and the yield on the 10-year US Treasury near 2.4%.

Five Interpretations of Unusual Events

So what’s driving the high prices for both stocks and bonds? There are different forces at work, but here are five theories—some interrelated—that help explain what’s happening:

1. **US Treasuries have become a yield play**

The US is on a divergent path from other developed nations when it comes to monetary policy. With yields much lower in countries like Germany, US debt actually looks attractive, especially given the
expectations that the US dollar will rise compared with other currencies.

2. The recovery is stronger in the US than in other countries

Recent macroeconomic data and second-quarter earnings were both largely positive, which makes US stocks continue to look attractive. Continued low interest rates are also acting as a tailwind to counter the headwind of stretched valuations. And with the economic recovery stronger in the US than in other regions, particularly Europe, investors interested in equity exposure are coming here.

3. Treasuries are shelter for investors afraid of short-term risks

Investors with different time horizons are powering different asset classes. With significant short-term global risks—including geopolitical ones—investors with short time horizons may be flocking to Treasuries because they can’t wait to recoup potential losses. Conversely, investors with longer time horizons who need to meet their savings goals are investing in stocks.

4. Diversification helps in today’s somewhat schizophrenic environment

Fundamentals appear to be improving yet risks are significant, so investors may be buying stocks because of the positive economic data being reported while buying Treasuries as a hedge against risk.

5. Smaller movements appear bigger during the summer slowdown

The August buying activity in both stocks and bonds likely appeared exaggerated due to low trading volume during the summer vacation season. If this continues through September or October, that could be cause for concern—particularly if US Treasury yields continue to fall against a backdrop of improving economic data.

Implications for Investors

Reading the tea leaves, we believe that the yield curve will likely flatten but not invert—meaning short-term rates will probably rise while longer-term yields remain relatively low. Flatter yield curves imply that we won’t see a recession but could see slower long-term economic growth, since lower longer-term yields are a reflection of expectations for lower trend growth compared with pre-global financial crisis levels.
In this environment, we expect US bonds on the shorter end of the curve—rather than stocks—to be the most vulnerable asset class.

All in all, it’s an investment climate that comes with real risks yet offers opportunities as well. It’s critical for investors to be well-diversified, but also to make sure they’re matching their asset allocations with their time horizons. Strange days, indeed, but they don’t have to be bad ones.

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